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Banco BPI and the Reimbursement of Contingent Convertible Subordinated Bonds (CoCos)

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Abstract

Title: Banco BPI and the Reimbursement of Contingent Convertible Subordinated Bonds (CoCos)

This case study focuses on the BPI's recapitalization plan, its causes and the reasons for the early reimbursement of CoCos in June 2014. The need for a capital intervention and the subsequent subscription agreement with the Portuguese Government of €1 500 million Core Tier 1 instruments were the result of a temporary capital buffer for sovereign debt exposures imposed by the European Banking Authority. The capital increase, the positive earnings in 2012 and 2013, the improvements in the sovereign debt crisis, the implementation of Basel III, in addition to the public exchange offer and the conversion of deferred tax assets into tax credits are the main factors for concluding the entire recapitalization operation three years before the deadline.

Keywords: Capital Regulation, Sovereign Debt Crisis, Banco BPI, CoCos

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"BPI's need for state aid was exclusively due to the European Banking Authority's imposition of a temporary capital buffer for the exposures to European sovereign debt, valued at September 2011 market prices [...] The EBA temporary buffer is counterproductive. The introduction of Basel III rules would enable BPI to fully reimburse the CoCos"

Fernando Ulrich, CEO, Banco BPI[1]

In late 2011, Mr. Ulrich had reasons for concern. The European Banking Authority (EBA)[a] issued a formal Recommendation requiring banks to hold a temporary capital buffer against European sovereign debt exposures valued at September 2011 market prices. At that time, Banco BPI was highly exposed and in need of more capital to meet the new regulatory requirements. In order to comply with the new rules, BPI issued €1 500 million of contingent convertible subordinated bonds (CoCos) subscribed by the Portuguese Government in June 2012. The recapitalization was very expensive and prohibited shareholders to receive dividends. What happened? Was BPI properly addressing its risks? Would it have been possible to raise capital using other sources?

Caixa Geral de Depósitos and Millennium BCP also presented their recapitalization plans and issued CoCos in June 2012. Later, Banif and Banco Espírito Santo were also intervened by the Portuguese authorities in January 2013 and August 2014 respectively (see **Exhibit 1**). BPI was the first bank to fully reimburse the Government. Is it now sufficiently capitalized to face the challenges ahead?

[a] EBA was established in 2011 to ensure an effective and consistent prudential regulation across the European banking system. To achieve its goals, it can produce regulatory binding documents such as "Recommendations".

Banco BPI S.A.

Under the name of Sociedade Portuguesa de Investimento (SPI), the firm opened doors in 1981 with the main purpose of financing the private sector and the modernization of Portuguese industry. In 1985, SPI was transformed into an investment bank (Banco Português de Investimento), going public in 1986. From its foundation, BPI has grown both organically and by acquiring other banks. The bank consolidated its position in the commercial banking segment by acquiring Banco Fonsecas & Burnay (BFB) in 1991 and later Banco Borges & Irmão (BBI) and Banco de Fomento e Exterior (BFE) in 1996. The integration of BFB, BBI and BFE led to the creation of Banco BPI in 1998.[2]

The founder and currently the chairman of BPI is Mr. Artur Santos Silva. He was the CEO until the Shareholders' General Meeting of April 2004, being replaced by Mr. Fernando Ulrich after attaining the age limit of 62 laid down in the company bylaws[3]. Besides chairman of the Board of Directors, Mr. Santos Silva is also chairman of the Financial Risks Committee and of the Corporate Governance Committee. These two Committees as well as the other consultative bodies of the Board of Directors are exclusively composed by non-executive members[4] (see **Exhibit 2**). This governance policy, however, is no applied in several European banks, in which some of the consultative bodies are not totally independent from the Executive Committee (e.g. in some banks, the Financial Risks Committee[b] has members of the Executive Committee[c]). Moreover, the BPI's Executive Committee, to whom the Board has delegated the responsibility to conduct the day-to-day activity, is independent from any shareholder. This governance model aims to ensure a balanced management between the shareholders, the Board of Directors and the Executive Committee[5]. In addition, BPI is also recognized by the adoption of the best market practices in terms of communication and dissemination of information, being several times awarded Best Annual Report, Best Investor Relations and Best Corporate Governance Disclosure by the Investors Relations & Governance Awards (Deloitte, Diário Económico and Semanário Económico)[6].

[b] The Financial Risks Committee (or the equivalent) is responsible for recommending the amount and type of risks that a bank is willing to take (risk appetite). It is also responsible for monitoring to what extent the activities of the bank are consistent with the risk appetite that was defined.

[c] For example, Mr. Matías Rodríguez Inciarte from Santander is both Chairman of the Risk Committee and member of the Executive Committee.

BPI's Structure and Business

BPI's core activity is commercial banking, having also significant operations in investment banking (BPI's initial activity), asset management and insurance (see **Exhibit 3**). The two main operational markets are Portugal and Angola. In 2013, the total assets amounted to €42 billion, being La Caixa Group (46.2%), Santoro (19.47%) and Allianz (8.83%) the three main shareholders[7].

In Portugal, BPI is the forth largest private bank by assets, having about 6 000 employees and 600 branches, 1.7 million costumers and a market share of approximately 8% in loans and resources[8]. The domestic commercial banking activity is mainly composed by mortgage loans and corporate loans (see **Exhibit 4**).

Regarding the international commercial banking activity, BPI has a strong presence in Angola and Mozambique. BPI owns 51.1% of Banco de Fomento Angola (BFA), which in 2013 had total assets of €6.4 billion, serving more than 1 million costumers with more than 2 000 employees and about 175 branches. In Mozambique, BPI has a 30% stake of Banco Comercial e Investimento (BCI). In 2013, the BCI's total assets amounted to more than €2 billion, having more than 700 thousand costumers, about 2 000 employees and 130 branches[9].

In Investment Banking, BPI's Corporate Finance was part of some relevant transactions such as the merger between Zon and Optimus and the placement of the CTT's retail tranche in an IPO[d]. BPI also provides brokerage services and coverage of quoted companies (mainly from Portugal and Spain). BPI's Private Banking business volume had grown from €2 818 million in 2008 to €4 733 million in 2013[10].

In Asset Management, the funds managed by BPI varied from €8 621 million in 2008 to €7 905 million in 2013. These assets are mainly composed by unit trust (mutual) funds, pension funds and capital insurance. In 2013, BPI's Asset Management was leader in mutual funds management (15.3% share of the national market), third place in pension-fund management (15.7% share) and also third in the contracting of new capitalization insurance with guarantees (9.5% share)[11].

In the insurance area, BPI has a bancassurance partnership with the Allianz group. On the one hand, Allianz can sell insurance products via BPI's commercial network, benefiting from the bank's costumer base without having to expand its sales forces. On the other hand, BPI earns

[d] Zon and Optimus are two Portuguese telecom operators. CTT is the national postal service of Portugal.

additional revenues by selling insurance products, being a "one-stop shop" of financial services with small additional costs (BPI do not need additional employees or branches to sell the Allianz products). The amount of commissions from intermediation of insurance products rose from €32.5 million in 2008 to €38.8 million in 2013[12].

Asset and Liability Management

A commercial bank usually makes the most significant part of its revenues from loans, mainly mortgage and corporate loans[13]. In the case of BPI, mortgage loans represent the biggest share of the loan portfolio, having been quite stable since 2008. On the other hand, corporate loans, which are riskier and yield higher returns, have been decreasing since 2008. Considering the figures of the Credit at Risk ratio[e] and Loans to Deposits[f] (LTD) ratio from 2008 to 2013 and comparing with the other largest banks in Portugal (see **Exhibits 5** and **6**), BPI stands out by having a very conservative credit policy (both ratios have been comparably lower). Though, by taking a smaller risk in the loan portfolio, BPI was also generating less return, which in turn had been compensated by investing in sovereign debt. Basically, BPI was using the excess liquidity obtained from the low transformation of deposits into loans to invest it in sovereign bonds, especially after 2009 (see **Exhibit 7** and **Exhibit 8**).

This ALM strategy carried many risks, among which the interest rate risk, the credit default risk and the liquidity risk. The interest rate risk is the impact of a possible interest rate increase on the value of the sovereign debt portfolio (the higher the interest rates, the lower the price of bonds). Furthermore, the higher the yields demanded by investors, the higher is the perception that a negative credit event will occur. In the case of default, the respective sovereign asset would be partially or completely written-off, representing a loss to the bank (credit default risk). As regard to liquidity risk, BPI was borrowing short to invest in long-term assets (maturity transformation), exposing itself to the risk of not being able to refinance its assets as liabilities become due. In a financial stress scenario, this could imply the need for selling assets at discount ("fire sale") to meet its short-term debt obligations. In principle, this risk was mitigated as long as credit ratings of sovereign assets did not suffer any downgrades

[e] Credit at Risk ratio is the ratio between credit at risk and loans to costumers. Credit at risk includes loans in arrears for more than 90 days, falling-due loans associated, restructured loans and insolvencies that have not yet been included in loans in arrears for more than 90 days. A low ratio means that the banking is taking less risk.

[f] The LTD ratio is the ratio between net loans and deposits. A high LTD ratio means that the bank may not have enough liquidity to cover for unforeseen funding requirements (e.g. in liquidity crisis). On the other hand, a low LTD ratio means that the bank is at low risk and that may not be generating as much return as it could be. The Bank of Portugal recommended a LTD ratio of 120% by the end of 2014.

(sovereign bonds were eligible as collateral by the European Central Bank (ECB) with a small haircut[g]).

Considering the ALM strategy of BPI, the need to require Government support seemed unlikely. In fact, BPI had low Credit at Risk ratios, low LTD ratios, it had been decreasing the exposure to corporations and it had collateral to get ECB funding. So, what went wrong?

How much capital is enough?

In the aftermath of a financial crisis, to correct deficiencies in the regulatory structure, regulators tend to set up new measures. The amount of capital banks should be required to hold is usually at the center of the discussion. The higher is the capital base, the higher is the capacity of a bank to absorb unanticipated losses, being less likely to become insolvent, protecting depositors, creditors and even shareholders from bankruptcy costs. On the other hand, capital is very expensive, leading to higher borrowing costs and less credit to the economy[14].

The Sovereign Debt Treatment in Basel I and Basel II

The Basel Committee established the first set of capital adequacy rules in 1988. The introduction of Basel I determined the minimum requirement for own funds at 8%, where the numerator is the amount of own funds and the denominator the assets adjusted for risk (Risk Weighted Assetsor RWA)[15]. Basel I suffered from several shortcomings, among which some are related to sovereign debt risk assessment. For instance, according to Basel I, the capital allocated in a credit to a company rated AAA could be higher than the capital required for a sovereign rated BBB[16] (see **Exhibit 9**).

To overcome the failures of Basel I, the Basel Committee approved a new set of rules (Basel II) in 2004. The main change was in the way RWA were calculated, keeping the own funds ratio at 8% and introducing minor changes to the definition of eligible capital[17]. With Basel II, banks have to decide between two different approaches to address credit risk: the Internal Ratings-based (IRB) approach and the Standardized approach. The IRB approach relies on banks' own risk assessment, with risk weights being determined by the estimation of the

[g] Haircut is the fee that is charged in accordance with the risk of the collateral (the higher the rating, the smaller the haircut). For example, a haircut of 5% means that a bank offers 100 in eligible collateral and receives 95 in funds.

economic capital requirements based in parameters such as the Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD)[18].

In the case of the Standardized approach, risk weights are determined through the use of external credit ratings[h] (see **Exhibit 10**) [19]. Still, Basel II allowed banks to assign a zero risk weight for the exposures to the domestic currency debt of their own sovereigns[20]. Additionally, European Union (EU) authorities have also set a zero risk weight for banks' exposures to sovereign debt issued by any other EU member state[i] [21]. Moreover, the unrealized losses of sovereign bonds in the Available-for-Sale (AFS) [j] portfolio (the big majority of BPI's portfolio) had no impact on results or capital. This regulatory framework was a great incentive to build a significant portfolio of sovereign debt[22] while leading to a false sense of security[23].

BPI from the Subprime Crisis to the Sovereign Debt Crisis

While many European banks were severely affected by the subprime crisis, Portuguese banks did not suffer direct losses during the initial contagious phase (negligible direct exposure to complex toxic assets and less volatile real estate prices in Portugal). Actually, BPI managed to increase capital[k] and reinforce its solvability to the strongest indicator of the preceding 5 years, placing it in a comfortable position for the crisis, with a Core Tier 1 (CT1)[l] ratio of 8% in 2008[24]. Facing the severe constraints in the interbank money market[25], BPI kept a comfortable liquidity position by reducing short-term funding, accumulating a surplus liquidity position in the interbank money market in the second half of 2008, position that was reversed with the gradual improvement of the funding conditions in 2009 (see **Exhibit 11**). BPI neither suffered any downgrade by the three major rating agencies, nor appealed to any of the Government's guarantee measures, being the recourse to the ECB's exceptional funding facilities minimum as well.[26]

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[h] Higher rated assets are subject to lower capital allocation.

[i] EU authorities allowed banks following the IRB approach to stay permanently on the Standardized approach for their sovereign debt exposures.

[j] Assets in the AFS portfolio are measured at fair value, with unrealized losses being directly recognized in equity (shareholders reserves) and interests in the income statement (compiled from IAS 39). Basel II did not make banks to account for unrealized losses on AFS sovereign bonds (except in the case of an early sale or impairments).

[k] The capital reinforcement was essentially made through a €140 million share capital increase and the sale of 49,9% stake of BFA to Unitel (BPI currently holds 51,1% of BFA).

[l] Core Tier 1 is the best form of bank capital. It is essentially composed by share capital and retained earnings.

BPI's need for public intervention was then directly linked to the sovereign debt crisis, which in turn was triggered by the subprime crisis, banking sector problems and a structural problem of low growth, high deficit and high debt in some European countries. During 2008 and most of 2009, the main focus of financial markets was on the ECB's efforts to safeguard the financial stability of the banking system and not on the excessive debt level in Europe. In fact, sovereign debt markets remained calm until the report of much a larger than expected deficit/GDP ratios for the year 2009, particularly in Greece[27]. Reacting to this scenario, sovereign markets began to show considerable levels of stress, whereas Greek Government measures to raise taxes and reduce spending were not enough to convince investors and prevent borrowing costs from increasing. Eventually, Greece was unable to access the market and in May 2010, the European Commission, the ECB and the International Monetary Fund (IMF) agreed on a three year financial assistance plan of €110 billion[28].

Meanwhile, deep concerns also spread to Ireland and Portugal (see **Exhibit 12**). The former, about 6 months after Greece, negotiated a three year financial assistance package of €85 billion, mainly caused by a huge banking exposure to the domestic property bubble and the resulting need for the recapitalization of some important banks[29]. In the case of Portugal, the high deficit and debt level, combined with other structural imbalances and the political disagreement on austerity measures, led the country to call for assistance in April 2011[30].

The unfavorable developments continued in the following months and directly impacted BPI. The incapacity of Greece to reach the targets established under the economic adjustment program pushed the country to a second bailout. In February 2012, the Eurogroup formally announced the terms for an exchange offer for Greek public debt, materializing the involvement of the private sector in the debt restructuring operation, frequently referred to as PSI " Private Sector Involvement"[31]. BPI's total exposure to Greek sovereign debt amounted to €634 million.

"I have no pride in having bought Greek debt in that dimension at that time. It was a bad decision, a mistake"[32]

Mr. Ulrich's words at the 2011 results' presentation well reflect his disappointment. Banco BPI's exposure to Greek debt implied losses of €559.7 million (€419.8 million after taxes), from which €451.8 million (€338.9 million after taxes) had already been recognized at the end of October 2011 through impairments and €107.9 million (€81 million after taxes) resulted from the PSI operation[33]. The bank recorded a consolidated net loss of €284.9 million in 2011 (see **Exhibit 13**).

BPI's Need for More Capital

Besides being exposed to Greek debt, BPI was also exposed to sovereign debt from Portugal, Italy and Ireland. At the peak of the crisis, the yields of these sovereign bonds were very high (see **Exhibit 14)** and the unrealized losses had no impact on results or capital. Therefore, both BPI and the other European banks with portfolios of sovereign debt were overestimating the amount of capital they had. Another sovereign default would lead the exposed banks to recognize large losses and probably to require a substantial Government intervention. This would initiate a dangerous cycle with unpredictable implications to the financial system and the global economy.

Under this scenario, to ensure that banks could withstand a wide range of shocks and still maintain an adequate level of capital, the EBA published a formal Recommendation in December 2011. In this new set of rules, EBA required banks to accommodate potential losses arising from their sovereign debt exposures by reaching "a level of 9% Core Tier 1 ratio by the end of June 2012" after a prudential valuation of sovereign debt at "market prices as of 30 September 2011". The capital buffer against banks' sovereign debt exposures was meant to be "exceptional and temporary" and it could not "be revised as a result of later market valuation changes and/or changes of the exposures" [34]. This last condition had the objective of preventing sales pressure on the sovereign debt secondary market.

$$Capital\ Shortfall_{Jun2012} = \left(0{,}09 \times RWA_{Jun2012} - CT1_{Jun2012}\right) + BufferSOV_{Sep2011}$$

Following the new rules, Banco BPI identified a capital shortfall of €1 389 million. A significant part of this amount (€1 359 million[m]) resulted from prudential valuation of sovereign debt (BufferSOV), which valued at September 2011 market prices evidenced significant losses[35] (see **Exhibit 15** and **16**).

In order to comply with the new rules, BPI and the Portuguese authorities approved a recapitalization plan in June 2012. The plan entailed the bank to enter into a subscription agreement with the Portuguese Government of €1 500 million contingent convertible subordinated bonds to be redeemed within 5 years. The plan foresaw a capital increase of €200 million, intending to reduce the exposure to €1 300 million until the end of September[36].

[m] Of the €1359 million capital buffer, €175 million corresponded to Greek debt exposure, for which BPI had already recognized impairments losses in 2011. Therefore, the temporary capital buffer was subsequently reduced to €1184 million (contrary to the initial €1359 million).

After issuing CoCos, BPI recorded a CT1 capital ratio of 9,4% under the EBA rules (above the 9%) and a CT1 ratio of 14,5% in accordance to the Bank of Portugal (BoP) rules (BoP required 10% by the end of 2012) [37].

The issuing of CoCos resulted in a big liquidity injection that the bank did not actually need. Therefore, to reduce the negative carry trade (the return on assets was not enough to cover for the increasing financing costs with CoCos), BPI acquired €3 322.3 million of Portuguese Treasury bills[38] in 2012. About 60% of this portfolio was constituted using resources obtained from the ECB's long-term refinancing operations (LTROs)[n], in which BPI was borrowing at 1% from the ECB and investing in Portuguese T-Bills with an average purchase yield of 3,5%[39]. Curiously, BPI requested the Portuguese Government support to create a temporary capital buffer against its sovereign debt exposure and after being recapitalized it further increased the exposure to Portuguese sovereign debt (the temporary capital buffer was fixed and the new bonds had no impact). This strategy reflected the bank's confidence in a positive evolution of the Portuguese financial situation.

The Role of CoCos

CoCos are hybrid instruments that banks may use to temporarily increase capital in periods of stress. CoCos are issued as interest bearing debt, being automatically converted in equity when certain predetermined triggers are met, namely if the capital ratio falls bellow certain level or when the issuer did not comply with the scheduled payment of interests or principal[40]. If the triggers are not met, CoCos work as normal bonds that are reimbursed at maturity. These mechanics are associated with the bail-in mechanism, in which under adverse circumstances, the creditors bear part of the burden by having part of their own debt written-off (see **Exhibit 17**)[o]. The high level of subordination and the risks of being converted imply that the interests charged would have to be very high (see **Exhibit 18**). Moreover, since the temporary capital buffers are intended to absorb potential (contingent) losses against sovereign debt exposures, EBA allowed newly issued CoCos to be considered as CT1 as long

[n] LTROs are 3-year special financial operations that involve the ECB lending money at very small interest rates to European banks. In the case of BPI, the Portuguese T-bills were used as collateral (the ECB waived the credit rating requirements to sovereign debt and therefore the applied haircut was very small).

[o] Contrary, in a bailout, outside investors rescue banks by injecting cash in the company. Usually, Government bailouts of banks are not well received by the general public because of its direct impact on taxpayers.

as they were consistent with the EBA's definition of contingent capital[p] (existing convertible capital instruments would only be eligible if converted according to the EBA's definition).

Besides being an expensive way to recapitalize, the issuing of CoCos also implied the prohibition on distributing dividends to shareholders, the non-payment of variable remuneration to the members of the Executive Committee and the usual reputational costs associated to a public intervention. However, even considering these costs, CoCos ended out to be the unique viable option to reinforce capital. The alternative of a capital increase resorting solely to private capital would imply a big drop in BPI's share prices and an enormous cash burden to the shareholders who wanted to keep their positions. Furthermore, the extra need of capital would be temporary and adjusted as soon as confidence in sovereign debt markets returns, making sense to use temporary sources of capital.

Even considering the hypothesis of an adverse scenario, the use of CoCos could have been advantageous. In fact, if sovereign debt markets had further deteriorated, it would be much more difficult and expensive to replace losses by issuing new equity. In this case, CoCos would provide an automatic and less expensive source of capital to restore solvency and the confidence of investors. In the case of the Portuguese Government, the subscriptions of CoCos prevented a direct intervention, protecting taxpayers while earning a positive net interest margin[q]. Still, the Government faced the risk of conversion, that is, the risk of taxpayers paying the bill of a bailout anyway.

All things considered, CoCos seemed to be a good temporary solution, providing BPI time to deleverage and reinforce capital with public funds, avoiding Government ownership and a huge cash burden to the shareholders. Nevertheless, it was expensive and an increasing risk for the Portuguese Government as time went by. A quick repayment of CoCos was then in the interest of all parties involved.

[p] In the Annex III of the December 2011 Recommendation, EBA sets up minimum requirements to be met. For example, it defines a "Core Tier 1 Contingency event" when the CT1 ratio (excluding CoCos) is below 7%.

[q] According to the IGCP (Portuguese Debt and Debt Management Agency) monthly bulletins from October 2012 to June 2014, the average Internal Rate of Return (IRR) in the loans received by the Government from the EU/IMF was 3,3% (BPI Press Release 25 June 2014).

The Quick Reimbursement

"From day one that our priority was to repay the Government"[41]

As laid down in the Recapitalization plan, BPI used the **€200 million** cash proceeds of the capital increase to repurchase CoCos from the Portuguese Government[42]. In 2012 and 2013, BPI further reimbursed €380 million of the outstanding debt, where the positive earnings of **€249 million** and **€67 million** had a major contribution (the increase in retained earning compensated the reduction of CT1 due to the reimbursement of CoCos). Despite the still fragile economic situation in Europe, some encouraging signs also began to emerge in these two years.

In the wake of the Greek default, the apparent ability of the other bailed-out countries to meet the EU-IMF targets, together with the Mr. Draghi's promise to do "whatever it takes to preserve the euro" [43] increased the confidence of investors. Nonetheless, even after a consistent decline of sovereign bonds yields, the EBA's temporary capital buffer persisted constant. On several occasions, Mr. Ulrich publicly revealed his dissatisfaction with the EBA's delay in revising the temporary capital buffer requirement. Indeed, the sovereign bonds valued at 30 September 2011 market prices reflected much larger losses when comparing to the market prices in the following months.

"The world has changed since September 2011 and the EBA did not"[44]

If the capital buffer had been recalculated based on the exposure of BPI at 31 December 2012 market prices, the temporary capital needs would decrease from €1 184 million at the end September 2011 to €576 million at the end of December 2012, which would allow an additional reimbursement of €608 million. The sovereign debt market had further improved in 2013, which means that if the temporary buffer imposed by the EBA was dynamically reflecting market prices, or at least revised based on more recent dates, BPI would be able to reimburse a considerable amount of CoCos without taking any further measure to increase capital (see **Exhibit 19**).

"EBA listened us, but just partially"[45]

The day Mr. Ulrich so much desired came in July 2013. In view of the changes in the legal framework for assessing capital levels with the introduction of Basel III via the Capital

Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR)[r], the EBA replaced its 2011 Recommendation with a new measure on capital preservation. The new rule foresees that banks should maintain the "amount of capital needed for meeting the requirements set in the December 2011 Recommendation as at 30 June 2012" or waive the this requirements by meeting "on a continuous basis the minimum Common Equity Tier 1 requirements and the capital conservation buffer computed under the fully implemented CRD/CRR rules" [46]. In this context, to avoid the temporary capital requirements of the previous EBA's recommendation, BPI had to comply with a CT1 capital ratio of 7% without benefiting from the phasing-in period planned in those same CRD IV/CRR rules (see **Exhibit 20**).

At the end of 2013, now without the EBA's buffer requirement, and still holding €920 million CoCos to reimburse, BPI recorded a CT1 ratio of 15.6% under the CRD IV phasing-in rules (above the 8% capital benchmark set by the ECB's comprehensive assessment) and a CT1 ratio of 11.2% under the CRD IV fully implemented rules (see **Exhibit 21**), representing an excess capital of **€713 million** relative to the 7% minimum ratio. This excess of capital allowed BPI to request the redemption of €500 million CoCos in December 2013 (approved by the BoP in March 2014)[47]. In this way, by considering the figures of December 2013 and already bearing in mind the repayment of €500 million, the BPI's excess capital against the 7% requirement was €213 million. With still €420 million of CoCos to reimburse, BPI took some additional measures in 2014 to fully reimburse the Government.

The most relevant measure was the sale of 50% of the position held in medium and long-term public debt of Portugal and Italy at a notional amount of €850 and €450 million respectively. This operation was concluded in the first quarter (BPI had already sold its entire position in Irish debt at the end of 2013). The sale generated total capital losses of €102 million (€132 million before taxes) [48] but constituted an important source of liquidity to reimburse the remaining CoCos (the €500 million approved in December and reimbursed at the end of March and the last tranche of €420 million reimbursed at the end of June).

[r] Basel III was implemented in the European Union via the CRD IV/CRR legislation at 1 January 2014. The most relevant changes were at the definition of eligible capital, requiring banks to hold more and higher quality of capital. Basel III introduced the Leverage Ratio, the Liquidity Coverage Ratio and the Net Stable Funding Ratio as well as the Capital Conservation Buffer and the Countercyclical Buffer to be hold above the regulatory minimum outside periods of stress.

"In this new framework, we thought that the positions we had were too big and could subject the bank to a volatility that did not seem advisable to us"[49]

As argued by Mr. Ulrich, the main purpose of this transaction was to reduce volatility of capital ratios and to avoid a future need for a capital increase caused by market price fluctuations. Contrary to the previous legislations, with Basel III the unrealized losses on public debt become reflected in capital ratios at market prices at each moment[50].

Even considering the losses incurred with the sale, the appreciation in 2014 of the sovereign debt from Portugal and Italy contributed to increase CT1. Considering both the €132 million capital losses and the reduction of unrealized losses from €418 million at 31 December 2013, to €77 million at 30 June 2014, the portfolio had appreciated by €210 million, representing a CT1 increase of **€201 million**[51]. In the first quarter, BPI also sold subordinated bonds from European issuers (AXA and Old Mutual) with a positive impact on CT1 of **€86 million**[52].

Basel III also changed the treatment of deferred tax assets (DTAs)[s]. According to the new rules, DTAs "that rely on future profitability of the bank to be realised are to be deducted in the calculation of Common Equity Tier 1"[53]. To counteract this deduction and thus reducing the needs for further capitalization of Portuguese banks, the Government approved the conversion of DTAs into tax credits (tax authorities are essentially recognizing a debt and so the realization of this assets are not anymore dependent on the future profitability of the bank)[54]. The new legislation would enter in force in January 2015 and BPI estimated a CT1 increase of about **€200 million** (at 31 March 2014 it would be €227 million)[55]. To further raise capital, BPI carried a public exchange offer of preference shares and outstanding subordinated debt for new shares of Banco BPI in June 2014. The offer has been accepted by 91% of holders and increased CT1 by **€113 million**[56].

All those measures carried in 2014 allowed BPI to repay the last tranche of CoCos at 25 June 2014 (see **Exhibit 22**), two years after asking for a Government intervention. The bank close its recapitalization operation with a CT1 ratio of 8.6% according to the CRD IV /CRR fully implemented rules and of 9.9% if already considering the conversion of DTA's into tax credits[57]. In addition, BPI also complied with the new Leverage and Liquidity Standards

[s] DTAs are related with temporary differences that arise from events that occur in one period, with taxes being recognized in another period. For example, a bank may incur in "tax losses" and carryforward to next years, being the realization of DTAs dependent on the future profitability of the bank.

established by Basel III[t] (BPI's Leverage Ratio (LR) was 4.7%[58], being the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) 216% and 103% respectively[59]). Banco BPI paid €167 million of interests in these 2 years[60].

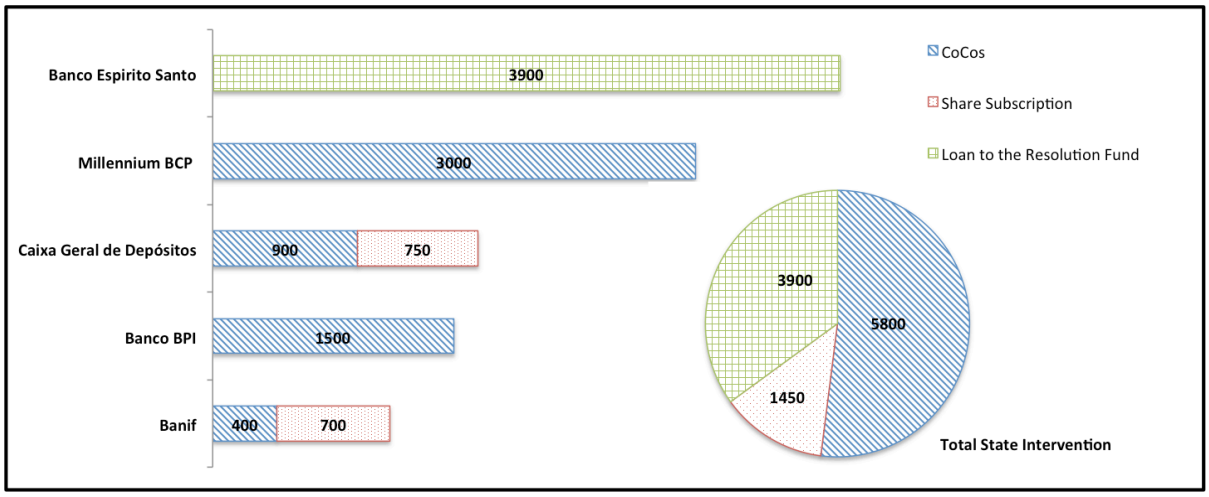
Clean Exit?

BPI was the first bank in Portugal to fully reimburse the Government, and have done so three years before the deadline. BPI's need for a Government intervention was mainly triggered by the exposure to sovereign debt and a subsequent imposition of a temporary capital buffer. Therefore, the improved conditions in the sovereign debt markets and the end of the EBA's sovereign buffer allowed BPI to reimburse a significant amount of CoCos. Other factors, such as the capital increase, the positive earnings in 2012 and 2013, the conversion of deferred tax assets into tax credits and the public exchange offer also contributed to reimburse the remaining CoCos and to meet the new and more restrictive regulatory rules of Basel III.

In fact, BPI managed to fully comply with both capital and liquidity standards of Basel III in record time. The bank is undoubtedly well capitalized, liquid and less exposed to sovereign debt market price fluctuations. However, under the new regulatory framework, banks are required to hold more capital and other stable sources of funding to invest in more liquid assets, meaning that they are paying more to finance their activity and generating less return from their assets. To what extent are regulators requiring too much capital? With Basel III, banks need to attract shareholders more than ever before, and those require a competitive rate of return[61]. Having less profitable but safer banks is not necessarily bad as long as they deliver shareholder value. Will BPI be able to deliver?

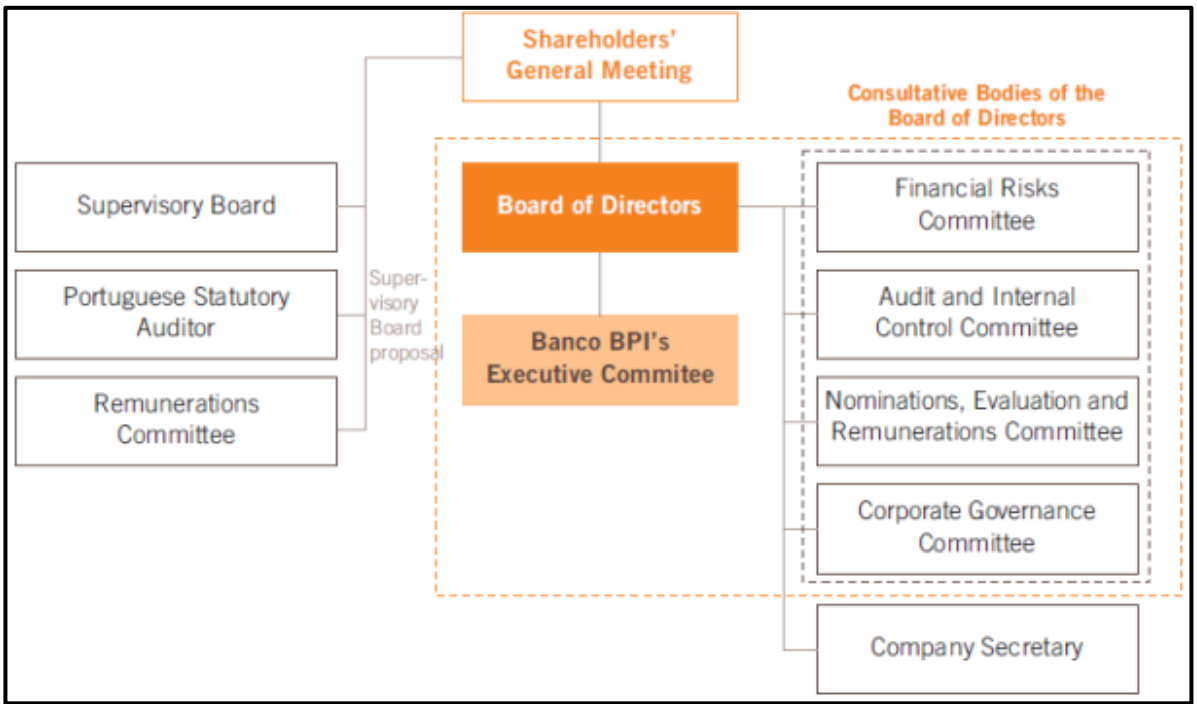
t $LCR = \frac{Stock\ of\ high\ liquid\ quality\ assets}{Net\ cash\ outflows\ over\ 30-day\ horizon} > 100\%$ $NSFR = \frac{Available\ amounts\ of\ stable\ funding}{Required\ amount\ of\ stable\ funding} > 100\%$ $LR = \frac{Tier\ 1\ Capital}{Total\ Exposure} > 3\%$

Exhibit 1 – Portuguese Authorities' Intervention in each Bank (EUR million)



Source: Compiled from European Commission and Reuters at http://europa.eu/rapid/press-release_IP-13-738_en.htm, http://europa.eu/rapid/press-release_IP-13-31_en.htm and http://www.reuters.com/article/2014/08/07/Portugal-bes-idUSL6N0QD6EF20140807?type=companyNews, accessed September 16, 2014.

Exhibit 2 – BPI's Management and Control Bodies



Source: Banco BPI at http://bpi.bancobpi.pt/index.asp?riIdArea=AreaGovGbpi&riId=OCManagementControlBodies, accessed November 29, 2014.

Exhibit 3 – Capital Allocated to the Main Units of the BPI Group (at 31 December 2013)

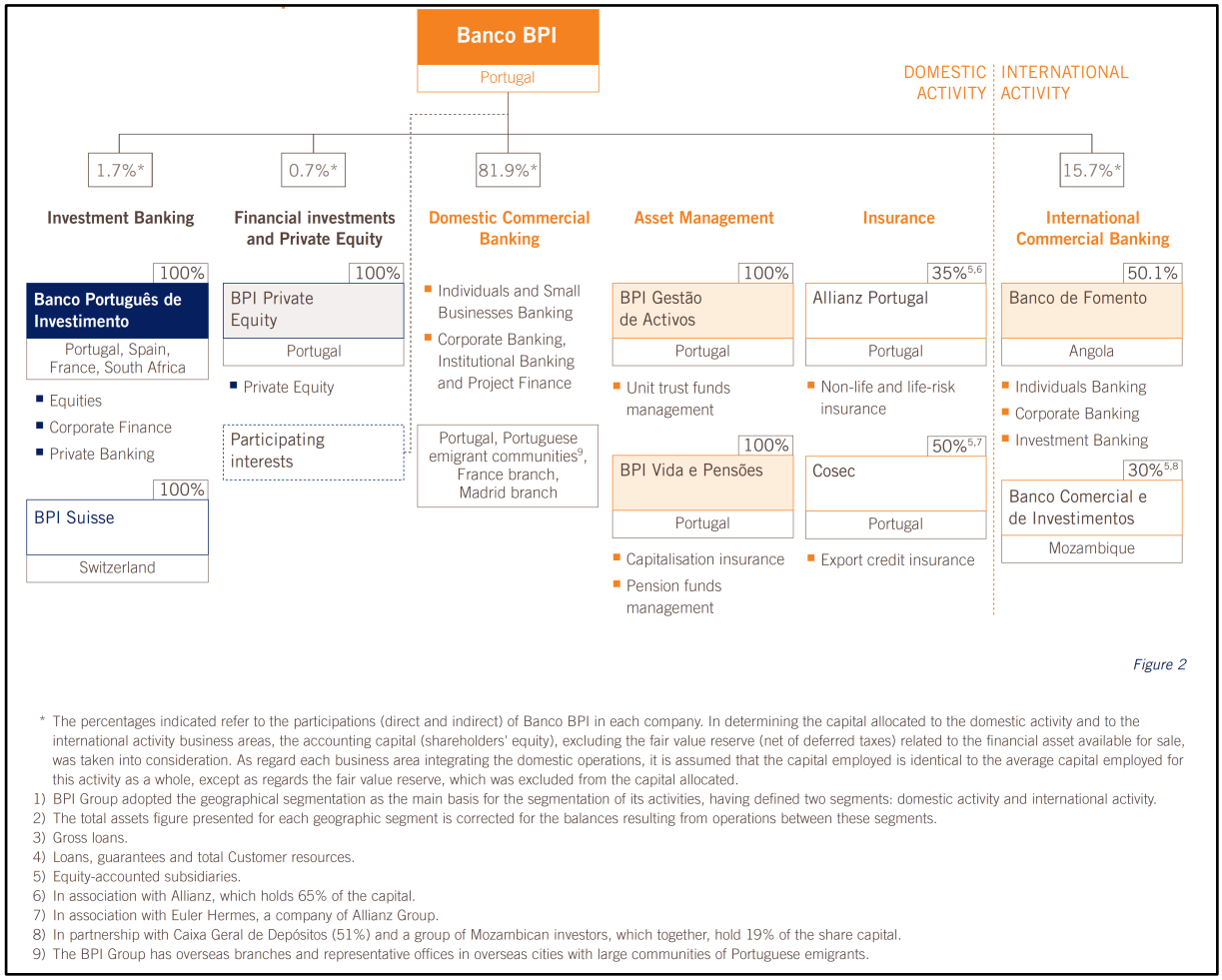


Figure 2

* The percentages indicated refer to the participations (direct and indirect) of Banco BPI in each company. In determining the capital allocated to the domestic activity and to the international activity business areas, the accounting capital (shareholders' equity), excluding the fair value reserve (net of deferred taxes) related to the financial asset available for sale, was taken into consideration. As regard each business area integrating the domestic operations, it is assumed that the capital employed is identical to the average capital employed for this activity as a whole, except as regards the fair value reserve, which was excluded from the capital allocated.

1) BPI Group adopted the geographical segmentation as the main basis for the segmentation of its activities, having defined two segments: domestic activity and international activity.
2) The total assets figure presented for each geographic segment is corrected for the balances resulting from operations between these segments.
3) Gross loans.
4) Loans, guarantees and total Customer resources.
5) Equity-accounted subsidiaries.
6) In association with Allianz, which holds 65% of the capital.
7) In association with Euler Hermes, a company of Allianz Group.
8) In partnership with Caixa Geral de Depósitos (51%) and a group of Mozambican investors, which together, hold 19% of the share capital.
9) The BPI Group has overseas branches and representative offices in overseas cities with large communities of Portuguese emigrants.

Source: Banco BPI at http://bpi.bancobpi.pt/index.asp?riIdArea=AreaGbpi&riId=BGlance, accessed November 29, 2014.

Exhibit 4 – BPI's Domestic Commercial Banking Loans and Resources (EUR million)

	2008	2009	2010	2011	2012	2013
Loans and Guarantees to Individuals and Small Banking Business	15 540.5	15 845.5	16 160.0	15 418.3	14 460.0	13 806.3
From which Mortgage Loans	*11 550.1*	*11 896.5*	*11 394.3*	*12 116.7*	*11 793.3*	*11 386.5*
(% from total)	*(74%)*	*(75%)*	*(71%)*	*(79%)*	*(82%)*	*(82%)*
Costumer Resources from Individuals and Small Banking Business	20 564.6	22 562.2	22 357.1	21 896.7	22 006.6	22 326.7
Loans and Guarantees to Corporate Banking, Institutional Banking and Corporate Finance	15 839.3	15 736.7	15 152.3	13 753.3	12 325.1	10 434.8
From which Corporate Loans	*8 789.9*	*8 697.4*	*7 939.4*	*7 282.1*	*5 302.2*	*4 049.9*
(% from total)	*(55%)*	*(55%)*	*(52%)*	*(53%)*	*(43%)*	*(39%)*
Resources from Corporate Banking, Institutional Banking and Corporate Finance	1 744.0	1 898.8	2 105.3	2 229.7	2 183.9	2 518.9

Source: Compiled from Banco BPI Annual Reports 2008 to 2013 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed December 4, 2014.

Exhibit 5 – Credit at Risk ratio (Credit at Risk/ Loans to Costumers)

	2008	2009	2010	2011	2012	2013	1st H 2014
Banco BPI S.A.	1.7%	2.4%	2.7%	3.2%	4.2%	5.1%	5.4%
Caixa Geral de Depósitos	n.d	n.d	4.2%	6.9%	9.4%	11.3%	11.9%
Millennium BCP	3.5%	6.0%	7.1%	10.1%	13.1%	11.9%	11,9%
Banco Espírito Santo S.A.	n.d	n.d	5.0%	6.6%	9.4%	10.6%	11,5%
Banco Santander Totta S.A.	n.d	n.d	1.8%	2.84%	4.3%	5.9%	5.7%

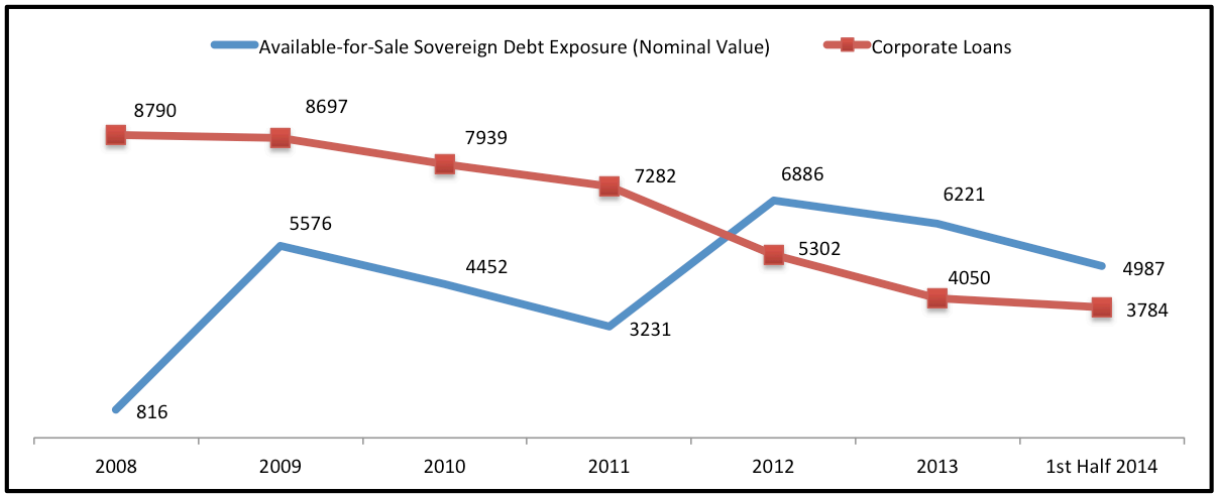
Source: Compiled from Banco BPI, Caixa Geral de Depósitos, Millennium BCP, Banco Espírito Santo and Banco Santander Totta Consolidated from 2008 to 1st half of 2014, accessed November 29, 2014.

Exhibit 6 – Loans to Deposits Ratio (Net Loans / Costumer Deposits)

	2008	2009	2010	2011	2012	2013	1st H 2014
Banco BPI S.A.	112%	132%	122%	109%	106%	96%	92%
Caixa Geral de Depósitos	136%	134%	136%	122%	112%	104%	101%
Millennium BCP	168%	163%	164%	145%	129%	117%	116%
Banco Espírito Santo S.A.	178%	192%	165%	141%	137%	121%	126%
Banco Santander Totta S.A.	160%	162%	158%	140%	125%	127%	127%

Source: Compiled from Banco BPI, Caixa Geral de Depósitos, Millennium BCP, Banco Espírito Santo and Banco Santander Totta Consolidated from 2008 to 1st half of 2014, accessed November 29, 2014.

Exhibit 7 – BPI's Corporate Loans and Available-for-Sale Sovereign Debt Exposure (in nominal values) from 2008 to First Half 2014 (EUR million)



Source: Compiled from Banco BPI Consolidated Results from 2008 to First Half 2014 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed December 8, 2014.

Exhibit 8 – Simplified ALM's Strategy of Banco BPI (Borrowing from Deposits and Investing in Sovereign Debt)

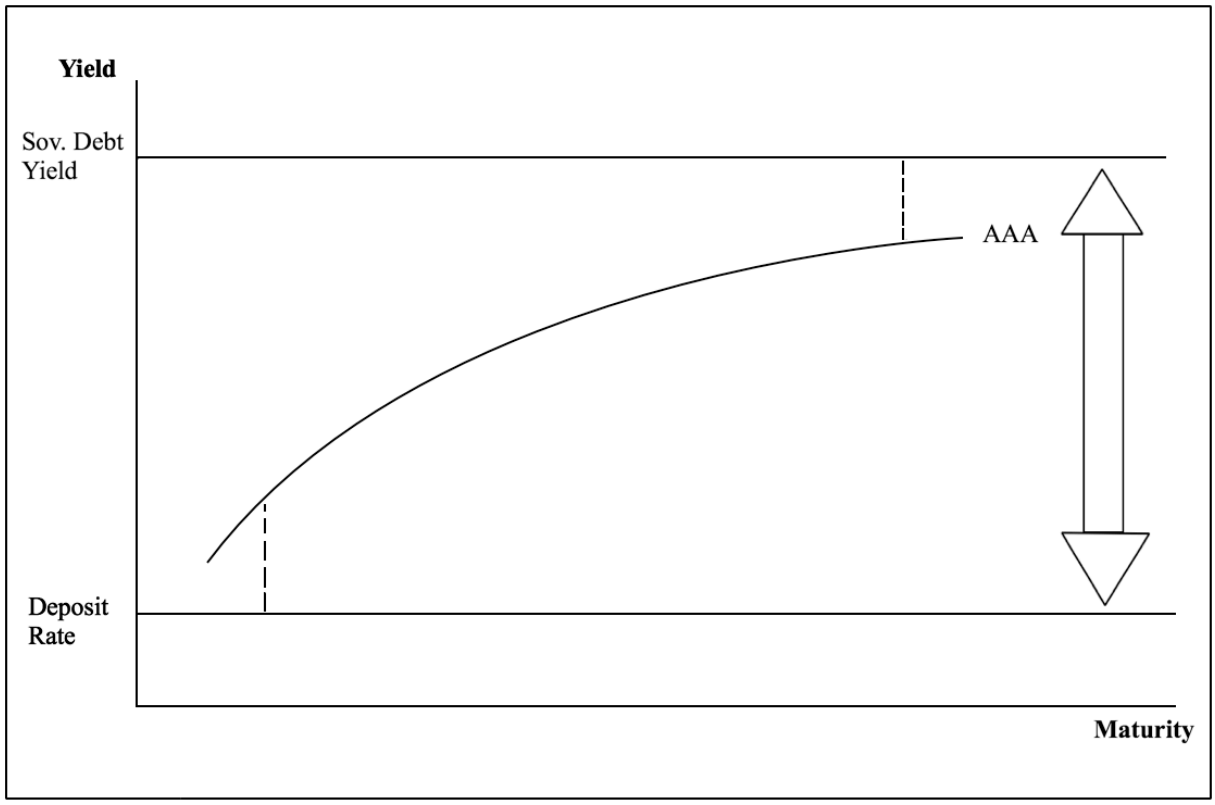


Exhibit 9 – Basel I Risk Weights for Different Asset Classes

Improvement with Basel III	Temporary Capital Needs
0%	Cash, Central Bank Deposits, Sovereigns OECD...
20%	Interbank market, public sector entities...
50%	Mortgage on Residential Property...
100%	All other assets...

Source: Compiled from Basel Committee on Banking Supervision, "INTERNATIONAL COVERAGE OF CAPITAL MEASURMENT AND CAPITAL STANDARDS, July 1988, p.21 and p.22, at http://www.bis.org/publ/bcbs04a.pdf, accessed October 17, 2014.

Exhibit 10 –Sovereign Risk Weights under the Standardized Approach

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

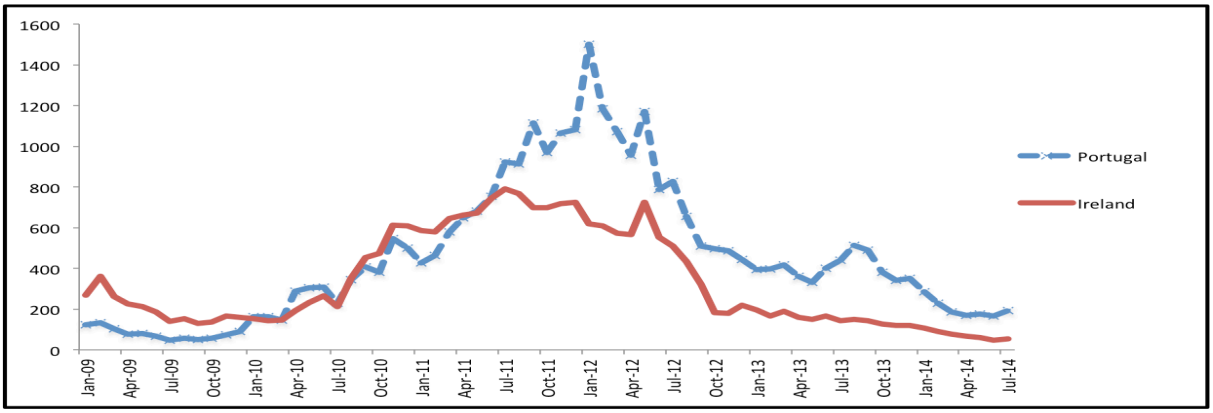
Source: Compiled Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards A Revised Framework" p. 19, June 2006, at http://www.bis.org/publ/bcbs128.pdf, accessed October 21, 2014.

Exhibit 11 – BPI's Consolidated Balance Sheet (EUR million)

	2008	2009	2010	2011	2012	2013	1º H 2014
ASSETS							
Cash and deposits at central banks	1 088.3	1 443.3	1 328.2	1 145.1	1 269.4	1 372.2	1 274.3
Loans and advances to other credit institutions repayable on demand	227.1	296.7	338.6	384.8	453.4	466.9	344.7
Loans and advances to credit institutions	3 504.2	2 347.8	1 439.1	2 337.6	1 710.7	1 886.1	2 021.0
Loans and advances to Customers	29 275.2	29 955.6	30 055.0	28 318.3	27 345.5	25 965.1	25 190.6
Financial assets held for trading and at fair value through profit and loss	2 853.6	1 791.1	1 241.7	937.5	1 111.6	1 295.8	1 895.2
Financial assets available for sale	3 262.6	8 935.0	8 156.3	6 778.1	10 252.9	9 694.2	8 633.6
Financial assets held to maturity	407.7	803.1	1 043.6	766.2	445.3	136.9	103.5
Hedging derivatives	484.4	316.5	250.3	279.8	280.7	194.0	137.0
Investments in associated companies and jointly controlled entities	137.9	158.9	194.2	179.2	202.3	222.0	224.4
Investment Properties							156.8
Other tangible assets	331.7	253.6	252.1	225.1	210.7	197.3	193.5
Intangible assets	15.4	9.7	6.4	9.6	14.0	19.1	18.6
Tax assets	250.4	213.5	430.6	903.5	617.7	539.7	468.9
Other assets	1 165.1	924.4	923.8	691.1	650.4	710.4	624.2
Total assets	**43 003.4**	**47 449.2**	**45 659.8**	**42 955.9**	**44 564.6**	**42 699.7**	**41 286.3**
LIABILITIES AND SHAREHOLDERS' EQUITY							
Resources from central banks		2 773.4	1 245.5	2 499.2	4 270.9	4 140.1	3 055.0
Resources from other credit institutions	2 007.4	4 702.7	4 726.1	2 071.5	2 568.4	1 453.2	1 682.4
Customers resources and other loans	25 633.6	22 617.9	23 240.9	24 671.3	24 6211	25 495.0	25 600.4
Debt securities	6 417.8	9 083.6	7 782.3	6 692.0	3 787.6	2 598.5	2 419.2
Technical provisions	2 246.4	2 139.4	2 991.9	2 625.2	2 255.4	2 689.8	3 211.4
Financial Liabilities associated to transferred assets	2 070.8	1 764.6	1 570.4	1 414.6	1 591.0	1 387.3	1 199.6
Hedging derivatives	596.5	423.8	499.4	661.9	815.0	548.5	319.6
Provisions	77.6	89.7	110.6	128.2	138.4	123.8	112.9
Tax liabilities	62.8	61.2	37.7	32.9	120.2	57.6	54.2
CoCos					1 200.3	920.4	
Other subordinated loans	796.3	664.2	647.6	214.5	156.3	136.9	69.5
Other liabilities	1 133.0	826.1	843.5	1 122.2	979.3	842.4	1 021.6
Share capital	900.0	900.0	900.0	990.0	1 190.0	1 190.0	1 293.1
Share premium account and reserves	458.2	784.6	373.6	-222.8	278.6	678.7	1 035.6
Other capital instruments	12.3	10.5	9.9	8.0	8.6	3.4	3.7
Treasury stock	-22.6	-23.0	-21.7	-21.0	-18.3	-17.1	-8.2
Net profit	150.3	175.0	184.8	-284.9	249.1	66.8	-106.6
Minority interests	463.4	455.7	517.4	353.0	352.7	384.4	323.0
Shareholders' Equity and minority interests	**1 961.5**	**2 302.7**	**1 963.9**	**822.4**	**2 060.6**	**2 306.3**	**2540.6**
Total liabilities and shareholders' equity	**43 003.4**	**47 449.2**	**45 659.8**	**42 955.9**	**44 564.6**	**42 699.7**	**41 286.3**

Source: Compiled from Banco BPI Financial Data, Annual Report 2009 p.126 Consolidated Results for the First Half 2014 p.25 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 12, 2014.

Exhibit 12 – 5 Years Sovereign Debt CDS Spread (bps)



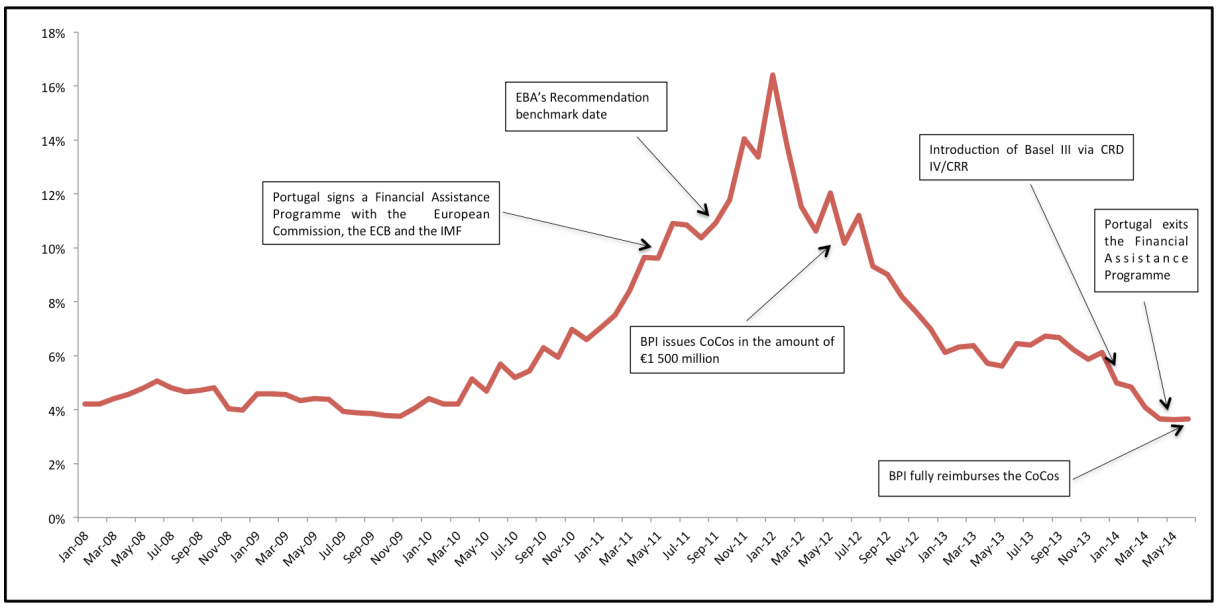
Source: Bloomberg at PORTG CDS USD SR 5Y and IRELND CDS USD SR 5Y, accessed September 24, 2014.

Exhibit 13 – BPI's Consolidated Income Statement (EUR million)

	2008	2009	2010	2011	2012	2013	1º H 2014
Net interest income (narrow sense)	642.9	584.3	626.4	543.3	548.9	444.7	220.7
Unit linked gross margin	6.5	3.3	4.1	3.8	2.7	3.0	2.0
Income from securities (variable yield)	5.6	4.9	3.7	1.6	3.5	3.7	3.4
Commissions related to deferred cost (net)	21.2	24.7	30.3	28.0	27.5	23.8	10.5
Net interest income	**676.2**	**617.1**	**664.5**	**576.8**	**582.6**	**475.1**	**236.5**
Technical result from insurance contracts	-12.2	11.8	16.1	-30.1	23.0	24.8	14.9
Commissions and other similar income (net)	305.5	311.4	313.9	297.0	332.3	310.3	146.9
Profits from financial operations	20.7	215.0	119.2	206.2	401.4	261.5	-57.3
Operating income and expenses	191.6	9.4	-14.9	-29.7	-9.3	-23.7	-12.5
Net operating revenue	**1 181.8**	**1 164.8**	**1 098.8**	**1 020.1**	**1 330.0**	**1 048.1**	**328.6**
Personnel costs, excluding non-recurring	-419.4	-400.2	-395.4	-378.1	-381.3	-366.8	-181.3
Outside supplies and services	-225.9	-222.0	-232.1	-230.8	-233.4	-232.4	-121.0
Depreciation of fixed assets	-52.5	-52.7	-45.2	-36.8	-33.1	-31.4	-15.0
Operating costs, excluding non-recurring	**-697.7**	**-675.0**	**-672.8**	**-645.8**	**-647.8**	**-630.5**	**-317.3**
Non-recurring costs			-36.1	-39.9	8.5	-20.0	
Operating costs	**-697.7**	**-675.0**	**-708.8**	**-685.7**	**-639.3**	**-650.5**	**-317.3**
Operating profit before impairments	**484.1**	**489.8**	**389.9**	**334.4**	**690.7**	**397.5**	**11.3**
Recovery of loans written-off	25.9	21.2	15.9	20.3	15.5	17.6	8.5
Loan provisions and impairments	-143.7	-166.4	-121.1	-213.2	-269.4	-272.6	-100.1
Other impairments and provisions	-146.6	-43.6	-29.1	-498.1	-36.8	12.0	-6.3
Profits before income tax	**219.7**	**301.0**	**255.5**	**-356.5**	**400.1**	**154.5**	**-86.7**
Corporate income tax	-51.4	-45.4	5.9	141.2	-88.3	-20.4	18.3
Equity-accounted results of subsidiaries	9.7	18.3	29.1	28.4	23.8	27.1	11.4
Minority shareholders' share of profit	-27.8	-98.9	-105.7	-98.0	-86.5	-94.4	-49.7
Net profit	**150.3**	**175.0**	**184.8**	**-284,9**	**249.1**	**66.8**	**-106.6**

Source: Compiled from Banco BPI Financial Data, Annual Report 2009 p.127 Consolidated Results for the First Half 2014 p.24 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 12, 2014.

Exhibit 14 – Portugal Government Bond 10 Years Yield



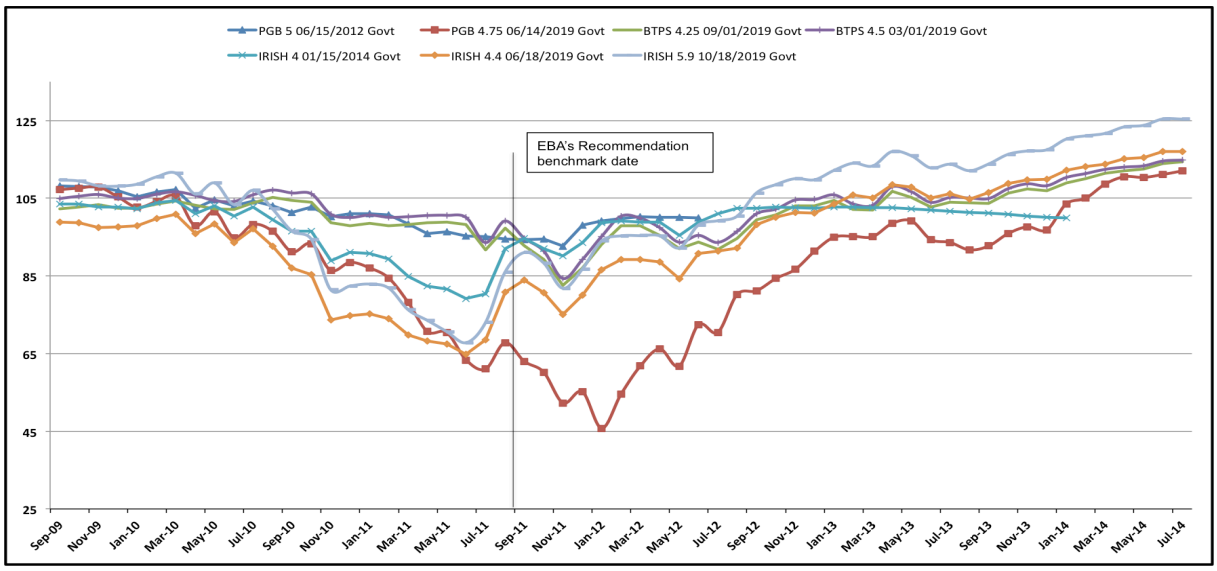
Source: Bloomberg at GSPY10Y

Exhibit 15 – BPI's Estimation of the Temporary Capital Buffer (EUR million)

Treasury Bonds	Exposure (Nominal Value)	Capital Buffer (30. Sep. 11)
OT - 5% - JUNHO - 2002/2012	1030	69
OT - 4.75% - 14.06.2019	1070	639
Portugal	**2730**	**708**
Buoni Poliennali Del T-4.25% - 01.09.2019	800	112
Buoni Poliennali Del T-4.5% - 01.03.2019	175	27
Italy	**975**	**139**
Irish Treasury - 4% - 15.01.2014	20	1
Irish Treasury - 4.4% - 18.06.2019	235	38
Irish Treasury - 5.9% - 18.10.2019	100	17
Ireland	**355**	**56**
Rep Grecia - 6% - 19.07.2019	480	175
Greece	**480**	**175**
Loans to central and local Administrations	**1058**	**281**
Capital buffer for sovereign risk exposures		**1359**
Amounts recognized in results (Greece)		-175
Temporary Capital Needs		**1184**

Source: Compiled from Banco BPI Recapitalization Plan June 2012 p.4 and Company Consolidated Results for 2012 p.3 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 12, 2014.

Exhibit 16 –Price Fluctuation of BPI's Portuguese, Italian and Irish Sovereign Bonds



Source: Compiled from Bloomberg and Banco BPI Recapitalization Plan June 2012 p.4 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 15, 2014.

Exhibit 17 – Conversion of CoCos in New Common Equity (EBA's trigger at 7% ratio)

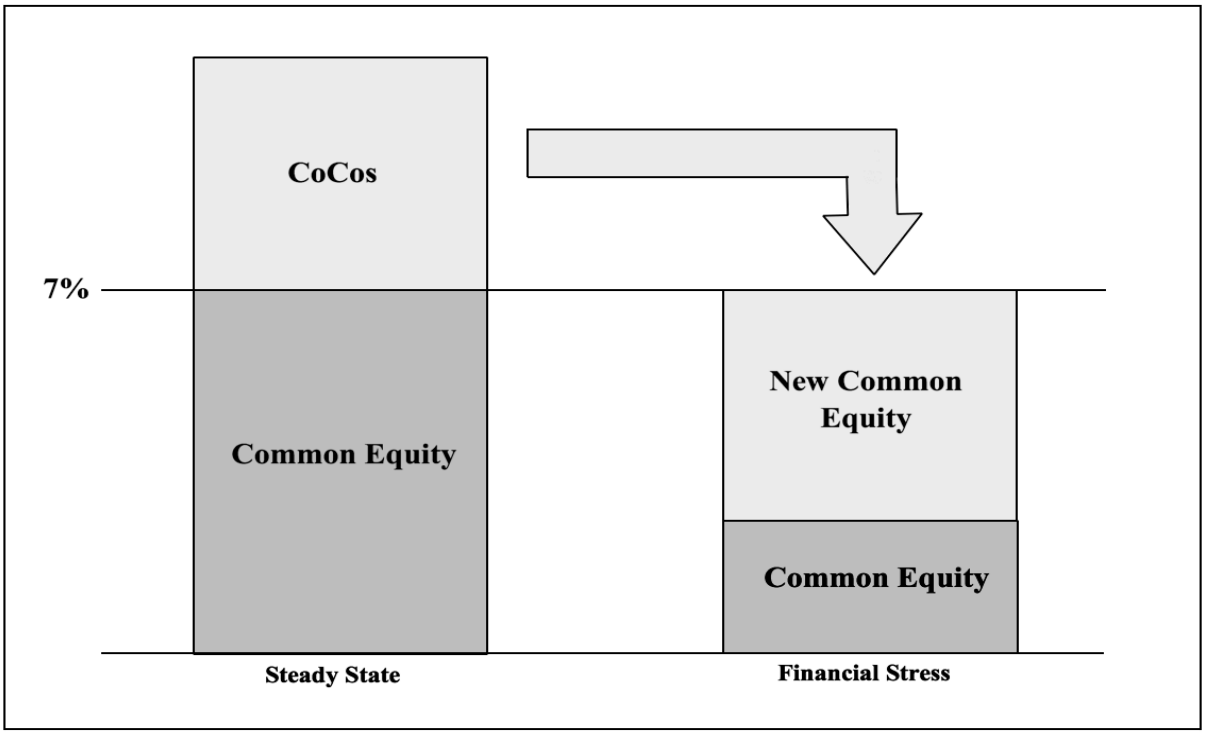
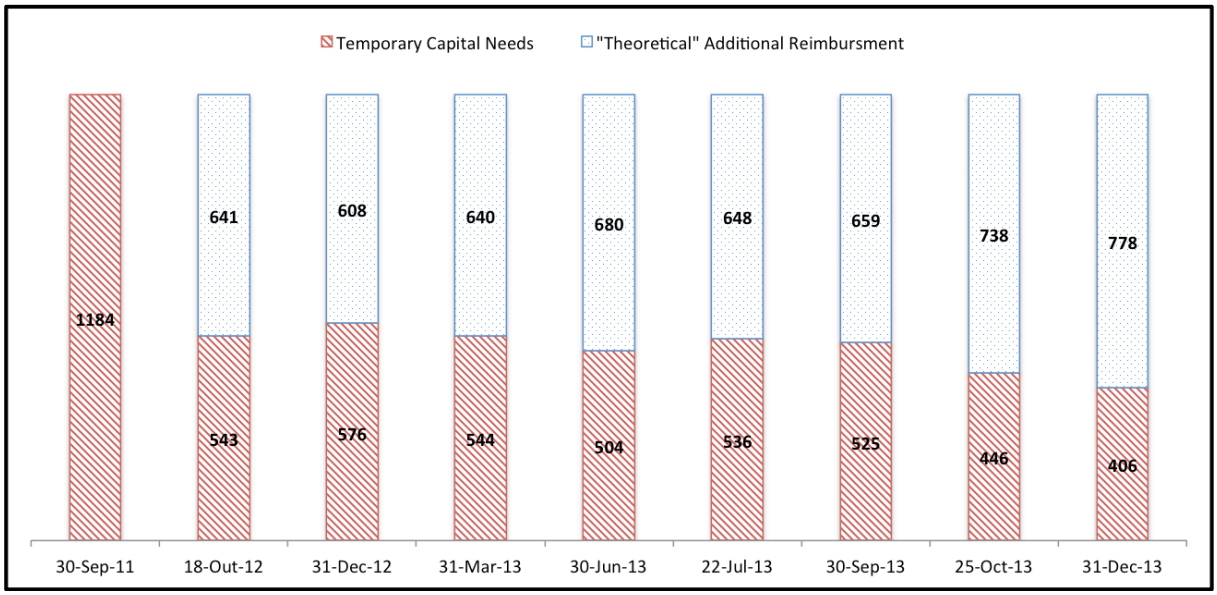


Exhibit 18 – CoCos' Annual Effective Interest Rates

Year 1	Year 2	Year 3	Year 4	Year 5
8.5%	8.75%	9%	9.5%	10%

Source: Diário da República, 2ª Série – Nº127 – 3 de Julho de 2012 at https://dre.pt/application /dir/pdf2sdip/2012/07/127000001/0001400027.pdf, accessed September 4, 2014.

Exhibit 19 – Recalculation of the Temporary Capital Buffer (EUR million)



Source: Compiled from Banco BPI Consolidated Results for the Third Quarter 2012 p.4, Year 2012 p.3, First Quarter 2013 p.3, First Half 2013 p.3, Third Quarter 2013 p.22 and Year 2013 p.5 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 30, 2014.

Exhibit 20 –Basel III Phase-in Arrangements

	2013	**2014**	**2015**	**2016**	**2017**	**2018**	**As of 1 Jan 2019**
Leverage Ratio	Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio	3.5%	4%	4.5%	4,5%	4.50%	4.50%	**4.5%**
Capital Conservation Buffer		-	-	0.625%	1.25%	1.875%	**2.5%**
Minimum common equity plus capital conservation buffer	**3.5%**	**4%**	**4.5%**	**5.125%**	**5.75%**	**6.375%**	**7%**
Phase-in deductions from CET 1 (including amounts exceeding the limit for DTAs, MSRs and Financials)		20%	40%	60%	80%	100%	**100%**
Minimum Tier 1 Capital	4.5%	5.5%	6%	6%	6%	6%	**6%**
Minimum Total Capital		8%	8%	8%	8%	8%	**8%**
Minimum Total Capital Minimum Total Capital plus conservation buffer	8%	8%	8%	8.625%	9.25%	9.875%	**10.5%**
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	Phased out over 10 year horizon beginning 2013						

Liquidity coverage ratio			Introduce minimum standard				
Net stable funding ratio						Introduce minimum standard	

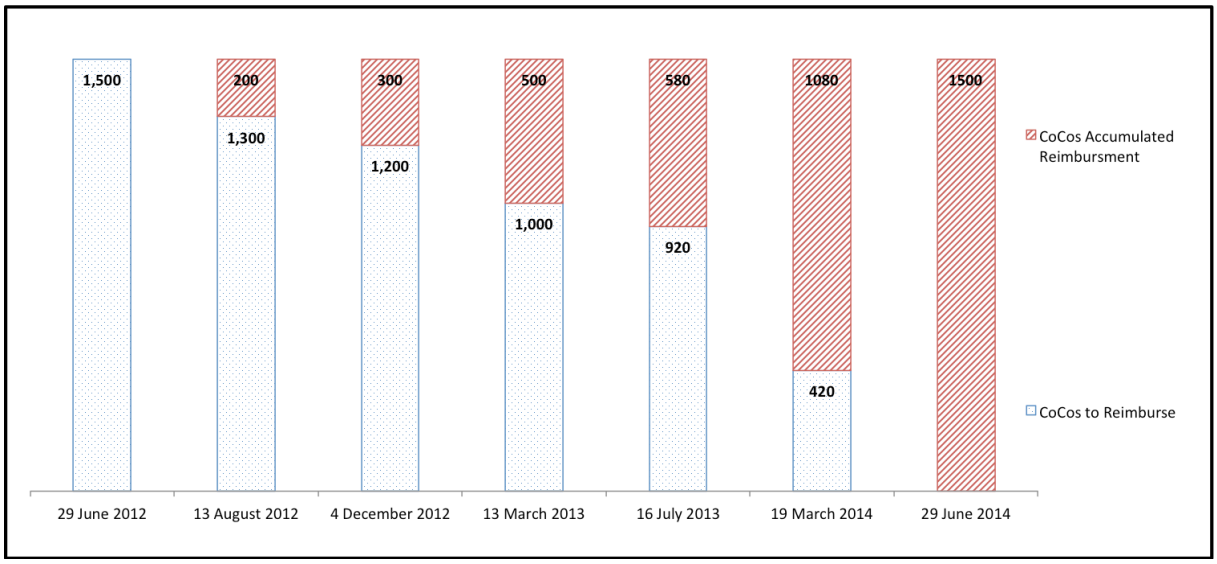
Source: Compiled from Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems", December 2010, Appendix 4 p.69 at http://www.bis.org/publ/bcbs189.pdf, accessed October, 27, 2014

Exhibit 21 – BPI's Estimation of Core Tier 1 Ratio according to different regulatory frameworks

		Bank of Portugal Rules	EBA (Rules December 2011)	CRD IV/CRR (Rules for 2014)	CRD IV/CRR *Fully Implemented*
EBA December 2011	**2nd Q 2012**	14.5%	**9.4%**	-	-
	3rd Q 2012	14.8%	**9.7%**	-	-
	4th Q 2012	15.0%	**9.8%**	13.1%	10.1%
	1st Q 2013	15.0%	**9.6%**	13.0%	9.7%
	2nd Q 2013	15.3%	**9.8%**	13.2%	8.8%
EBA July 2012	**3rd Q 2013**	15.2%	-	14.0%	**9.0%**
	4th Q 2013	16.5%	-	15.6%	**11.2%**
	1st Q 2014	-	-	13.2%	**9.7%**
	2nd Q 2014	-	-	12.5%	**8.6%**

Source: Compiled from Banco BPI Consolidated Results for the First Half 2012 p.4, Third Quarter 2012 p.1, Year 2012 p.1, First Quarter 2013 p.1 and p.3, First Half 2013 p.1, Third Quarter 2013 p. 20, Year 2013 p.1, First Quarter 2014 p.1 and First Half 2014 p.2 at http://bpi.bancobpi.pt/index.asp?riLang=en, accessed September 29, 2014.

Exhibit 22 – CoCos Reimbursement (EUR million)



Source: Compiled from Banco BPI Press Release at 25 June 2014, accessed September 30, 2014.

Endnotes

[1] Fernando Ulrich, "Buffer Regulations have been counterproductive for BPI", Fin*ancial Times*, May 23, 2013, at http://www.ft.com/intl/cms/s/0/b3974dfa-c22a-11e2-8992-00144feab7de.html#axzz3Etewkr80, accessed September 8, 2014.

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Nova School of Business and Economics

TEACHING NOTE January 2015

Banco BPI and the Reimbursement of Contingent Convertible Subordinated Bonds (CoCos)

Overview

In the wake of the subprime crisis, some European countries started to reveal serious structural problems. A weak decade of economic growth combined with high deficits and banking sector problems, namely in Ireland, led to a considerably explosion of the debt burden, which was followed by an increasingly demand for higher yields in sovereign bonds. Eventually, Greece, Ireland and Portugal became unable to access the markets and asked the European Union (EU) and the International Monetary Fund (IMF) for a bailout. Later, the incapacity of Greece to reach the targets established by the EU-IMF pushed the country to a second bailout. In February 2012, the Eurogroup formally announced a debt restructuring operation of the Greek's public debt denominated "Private Sector Involvement" (PSI). The default on Greek debt implied considerable losses in several banks (including BPI), having contagion effects in other vulnerable countries such as Portugal, Ireland, Spain and Italy.

Fears of another default and the potential contagion effect in banks led the European Banking Authority (EBA) to issue a Recommendation in December 2011. EBA required banks to meet a 9% Core Tier 1 ratio and to hold a temporary capital buffer against banks' exposures to sovereign debt valued at 30 September 2011 prices. Before these rules, banks were allowed to apply a zero risk weight to their European sovereign exposures and the unrealized losses in the Available-for-Sale portfolio did not have impact on results or capital. This implied that banks were overestimating their capital ratios (with the new rules, EBA wanted to ensure that banks could withstand a range of shocks and still maintain an adequate level of capital). At this time, BPI was highly exposed to sovereign debt, especially from Portugal, but also from Ireland and Italy. BPI estimated a temporary capital buffer of €1 184 million, issuing €1 500 of CoCos subscribed by the Portuguese Government in June 2012.

The issuing of CoCos implied several costs, namely the high interest rates, the prohibition of disturbing dividends to shareholders, the non-payment of the variable remuneration to the Executive Committee and the reputational costs associated with a public intervention. These costs constituted a big incentive for BPI to reimburse the Government as fast as possible.

Given that the BPI's need for public intervention was mainly caused by the exposure to sovereign debt, the improved condition in the sovereign markets combined with changes in the legal framework with the implementation of Basel III allowed the bank to promptly reimburse the Government. In addition, the capital increase, the positive earnings in 2012 and 2013, the public exchange offer and the conversion of deferred tax assets into tax credits further contributed to boost capital ratios and to fully reimburse the Government 3 years before the deadline.

BPI managed to meet the new and more restrictive rules of Basel III. The bank is well capitalized, it has more stable sources of funding and it is investing in more liquid assets. BPI is safer, but it is generating less return. Will BPI be able to generate enough shareholder value in the future?

Position in the Curriculum

The case was designed to be used at Nova School of Business and Economics (NovaSBE) in the Masters course of "Banking". It may be useful to use this case to study Asset and Liability Management and Capital Regulation.

Educational Objectives

1. To better understand the impact of different regulatory frameworks.
2. To explore the link between banks and their sovereigns.
3. To study the relationship between Asset and Liability Management and value creation.
4. To understand the mechanics of contingent convertible subordinated bonds (CoCos), their benefits and their costs.
5. To evaluate the costs and benefits of having too much capital.

Assignment

Students should read the case and answer to the following 10 questions (in report or Power Point format). To this end, the instructor may create working groups. Some groups may be required to present the case study in class.

Study Questions:

1. Why should the Financial Risks Committee be independent of the Executive Committee?
2. Comment on the partnership between Banco BPI and Allianz. Would be better for BPI to have its own insurance company?
3. How did BPI manage liquidity during the subprime crisis? What were the main implications of this strategy?
4. Why did BPI increase exposure to sovereign debt after 2009?
5. Were the EU regulatory authorities properly addressing the risk of sovereign debt? Why did EBA issue a Recommendation in December 2011?
6. Why did BPI asked for a Government intervention in 2012? What went wrong?
7. Why did BPI use CoCos? What is the logic of the bail-in process? What is the main difference compared to a bailout? What are the main risks?
8. What was the main factor for an early reimbursement of CoCos? Was it enough to meet the new and more restrictive rules of Basel III?
9. What was the impact of the BPI's recapitalization on taxpayers?
10. What are the advantages and disadvantages of having too much capital? What are the implications of the new Basel III liquidity standards?

Teaching Plan

The classroom session could proceed according to the following outline:

I. Presentation (30 minutes)

One group of students may present their work orally. It is not supposed to provide a detailed answer to each question, but rather a summary view about the main issues discussed in the case study. The presentation should not take more than 30 minutes.

II. Class Discussion (40 minutes)

The instructor may use this time to clarify some mistakes, to highlight the most relevant topics and to link the case study to the contents of the course.

III. Summary (10 minutes)

The instructor may want to use the "Overview" in the first page of this document to conclude the class.

Case Solutions

This section provides short answers to each question:

1. Why should the Financial Risks Committee be independent of the Executive Committee?

The Financial Risks Committee (FRC) defines the risk appetite of a bank as well it monitors the compliance with the defined risk policies. On the other hand, the Executive Committee (EC) is responsible for managing the day-to-day activity of a bank. Therefore, the FRC's main role is to monitor the performance of the EC, making sense that they are independent of each other (otherwise, a member of the EC that belongs to a FRC would be supervising its own activity). In this way, just a fully independent FRC (or any other consultative body of the Board of Directors) can effectively ensure full transparency in examining the management policies of a bank.

2. Comment on the partnership between Banco BPI and Allianz. Would be better for BPI to have its own insurance company?

The *bancasssurance* arrangement between BPI and Allianz seems to be beneficial for both parties. On the one hand, Allianz can expand its costumer base without having to expand its sales forces. On the other hand, BPI earns additional revenue by selling insurance products with small additional costs (no need for more branches or employees to sell the insurance products). If BPI would have its own insurance company, it would get higher commercial revenues (the revenues from selling insurance products will all belong to the bank), but it would incur in further costs (e.g. in the process of manufacturing insurance products), taking additional risks in a field where the bank has little experience.

3. How did BPI manage liquidity during the subprime crisis? What were the main implications of this strategy?

In 2008, at the implosion of the subprime crisis, BPI reduced short-term funding, managing to keep a surplus liquidity position in the interbank market (the "Resources from other credit institutions" were smaller than the "Loans and advances to credit institutions" in 2008 (Exhibit 11)). By getting a surplus position, BPI was lending more than borrowing in the interbank market and therefore financing itself through more stable sources of funding. Despite this strategy being good for liquidity purposes, it increased borrowing costs, having a negative impact on returns (which ended out being the main reason for reversing the surplus position in 2009).

4. Why did BPI substantially increase exposure to sovereign debt after 2009?

BPI increased exposure to sovereign debt to boost returns and take advantage of a very favorable regulatory environment. In fact, BPI has a conservative credit risk policy (low Credit at Risk and Loans to Deposits ratios in Exhibit 5 and 6) and since 2008 that loans to corporations have been decreasing (Exhibit 4). This strategy implied that the bank was generating less return. Therefore, to offset the decrease in returns, BPI substantially increased its exposure to sovereign debt (Exhibit 7 and 8). Furthermore, the bank could apply a zero risk weight for the exposure to any member state's sovereign debt (treated as risk free regardless of the credit rating). This was a great incentive to invest in sovereign debt instead of lending money to corporations, especially in a period of crisis where banks are short on capital and hesitant to lend.

5. Were the EU regulatory authorities properly addressing the risk of sovereign debt? Why did EBA issue a Recommendation in December 2011?

Before the EBA's Recommendation of December 2011, the sovereign debt from European countries was treated as risk free, meaning that banks were not required to hold any capital against their sovereign exposures (zero risk weight). With the Greek default, it became clear that sovereign debt was not risk free and that regulators were underestimating its risk. By requiring a 9% Core Tier 1 and a temporary capital buffer for sovereign debt exposures at unfavorable market prices, the EBA's Recommendation significantly increased the amount of capital banks should be required to hold, ensuring that they could withstand a range of shocks and still maintain an adequate level of capital (banks were accommodating for potential losses by valuing their sovereign portfolios at 30 September 2011 market prices).

6. Why did BPI ask for a Government intervention in 2012? What went wrong?

Following the new rules imposed by the EBA's Recommendation of December 2011, BPI identified a capital shortfall of €1 389 million. Almost the entire capital needs resulted from the temporary capital buffer against European sovereign debt exposures (Exhibit 15). Basically, BPI started to recognize the unrealized losses from its sovereign debt portfolio of European countries, which valued at September 2011, evidenced significant losses ("BPI's need for state aid was exclusively due to the European Banking Authority's imposition of a temporary capital buffer for the exposures to European sovereign debt, valued at September 2011 market prices" (Mr. Ulrich)). BPI was caught by an unexpected change of the regulatory framework while holding a significant portfolio of sovereign bonds in the Available-for-Sale portfolio.

7. *Why did BPI use CoCos? What is the logic of the bail-in process? What is the main difference compared to a bailout? What are the main risks?*

The need for issuing CoCos came essentially from the EBA's temporary capital buffer for sovereign debt exposures. The mechanics of CoCos provided a temporary solution to a temporary problem (if triggers are not met, CoCos work as normal bonds). In addition, the alternative of a capital increase would imply a huge cash burden to the shareholders who wanted to keep their positions.

CoCos are associated to a bail-in by establishing an automatic reinforcement of capital within banks' balance sheets, creating an effective mechanism to quickly generate equity in times of crisis (Exhibit 17). Contrary, a bailout is when an outside investor injects cash to help borrowers make debt payments (increase of capital from outside and not from within the balance sheet). The main risk of the bail-in mechanism is the potential negative reaction of bond markets, that is, the higher yield demanded by bondholders to face the risk of being "caught" by a bail-in.

8. What was the main factor for an early reimbursement of CoCos? Was it enough to meet the new and more restrictive rules of Basel III?

The need for issuing CoCos came essentially from the need of a temporary capital buffer for sovereign debt exposures valued at September 2011 market prices. With Basel III and the end of the capital buffer, the sovereign debt market price fluctuation became reflected in capital at each moment. Thus, the improvement in sovereign markets allowed to reimburse a significant part of CoCos (Exhibit 19). However, the decrease of government yields was not enough to meet the new and more restrictive rules of Basel III. In fact, in order to avoid the temporary capital buffer, BPI needed to comply with Basel III without benefiting from the phasing-in period. Therefore, the bank carried additional measures such as the capital increase, the public exchange offer and the sale of medium and long-term sovereign debt from Portugal and Italy to increase capital and reduce the volatility of capital ratios. The bank has also benefited from positive earnings in 2012 and 2013 and from the conversion of deferred tax assets into tax credits.

9. What was the impact of the BPI's recapitalization on taxpayers?

The impact on taxpayers can be estimated by the difference between the interests that the Government received from BPI and its funding costs (based on the footnote *q*, the average funding costs in that period was 3,3%). As seen in Exhibit 18, BPI paid 8,5% and 8,75% in the first and second year respectively. Taking a simple average, we obtain an average interest rate of 8,6%, which subtracted by 3,3%, gives an average interest margin of 5,3%. Knowing that BPI paid €167 million of interests, we can infer a Government gain of about 103 million. In this fashion, and contrary to what has became the public opinion, the recapitalization of BPI was not a burden, but rather a benefit to taxpayers.

10. What are the advantages and disadvantages of having too much capital? What are the implications of the new Basel III liquidity standards?

Risk and return trade-off. The more capital a bank has, the higher is the capacity to absorb unanticipated losses, protecting depositors, creditors and even shareholders from bankruptcy costs. Following the same reasoning, the more high quality liquid assets (higher LCR ratio) and stable source of funding (higher NSFR ratio) a bank has, the higher is the capacity to face liquidity shocks, reducing for example the price risk of a "fire sale". Essentially, Basel III requires more stable sources of funding (e.g. capital), which are more expensive, and more liquid assets, which give less return. In this way, banks are safer, but generate less return, which is not necessarily bad as long as they can generate enough shareholder value.